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STATE FOR EAP/CM AND EEB/IFD/OMA, TREASURY FOR OASIA

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TAGS: EFIN ECON HK CH
SUBJECT: HK ECONOMISTS DISMISS DOWNSIDE RISKS TO CHINESE
ECONOMY

Classified By: Acting Consul General Christopher Marut, Reason 1.4 b

¶1. (SBU) Summary: China macroeconomists in Hong Kong predict inflation and Renminbi (RMB) appreciation for 2010 but are not overly worried about asset bubbles or non-performing loans. The recent small interest rate increase and hike in reserve requirements were intended to show the market that Chinese economic policymakers are watching closely and will step in to tighten if needed. But with growth still dependent on loose monetary policy, officials will be reluctant to do too much, too soon. Overheating, caused by stronger-than-expected global demand, was the biggest risk they saw to Chinese economic growth. Loose monetary fiscal policies are already spurring high growth. Add resurgent exports and the Chinese government may be forced to rapidly tighten, with unforeseen consequences. But several months of export growth could also provide helpful cover for RMB appreciation. Economists warned that foreign pressure to allow the currency to strengthen would not be helpful. Observers agreed that China needed to rebalance its economy away from exports towards more domestic consumption, but this was a long-term goal likely to be delayed until the new Chinese leadership team was installed in 2012. End Summary.

¶2. (C) Hong Kong Economic Unit Chief and Beijing Deputy Financial Attach met with China economists Shen Minggao (Citibank), Helen Qiao (Goldman Sachs), Qu Hongbin (HSBC) and Ben Simpfendorfer (RBS) in Hong Kong January 22 to discuss the risk of inflation in China, asset bubbles, exchange rate policy, economic rebalancing and risks of non-performing loans in China's banking system.

Inflation Accelerating, China Wary of the Brake Pedal
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¶3. (C) Shen predicted that China's 2010 economy would face many of the same problems last seen in 2007, namely, loose money and global commodity price increases leading to asset bubbles and concerns about inflation, which he said might reach five percent by year's end. He noted that while China planned to restrict lending to just RMB 7.5 trillion in 2010, that was still over 50 percent above pre-2009 peak lending. Simpfendorfer noted that food and energy prices were increasing, in part due to bad weather in China, and that could spur inflationary expectations. Qiao and Qu also agreed that the risk of increased inflation this year was significant. The People's Bank of China's early January decision to raise its base rate 27 basis points was a signal to markets that the PBOC would not hesitate to tighten if necessary, said Qu. Qiao predicted that Chinese authorities would rely on administrative measures to cool the economy. Loan quotas and price controls could be in the cards, she said. But all agreed that with liquidity-driven growth, China would be cautious about tightening too much, too soon.

NPL = No Problem Loans
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¶4. (C) Rapid loan growth has raised the specter of non-performing loans (NPLs), but none of our interlocutors were overly concerned. Qiao believed only an economic "hard landing" or double-dip recession -- which she did not expect to occur -- could generate serious NPL problems, and in any case the government would not slow the flow of funding to ongoing projects. Shen acknowledged that an increase in NPLs stemming from China's unprecedented loan growth in 2009 was certain but argued that they wouldn't be a concern for several more years; if the amount of new NPLs grew too large, however, Shen believed they could worsen China's fiscal situation and undermine public confidnce in the Government. Continued rapid nominal growth would resolve the issue, said Qu. In the meantime, "evergreening" (rolling over debt with new loans) would prevent bad loans from showing up on bank books. Simpfendorfer agreed, noting that much of the short-term debt had been replaced by longer term borrowing. In any event, NPLs in infrastructure loans had historically been low, he said.

¶5. (C) Senior Chinese officials worried more about asset bubbles than NPLs, said Qiao, but she downplayed concerns that housing or equity prices were in bubble territory. She drew a distinction between the low and high end of the housing market, noting that prices for luxury properties were rising rapidly while lower-end property prices were more stable. Given that investors and speculators in the high-end often paid in full and in cash, Qiao questioned the effectiveness of government controls on lending, down payments, and higher interest rates. The government should focus on ensuring there was a sufficient stock of lower end

properties at reasonable prices and let the top of the market go where it would, she said. Shanghai equity prices, after leading the world in late-2008 and early-2009, now were lagging other regional markets and were not a worry.

Biggest Risk to China? U.S. Recovery

¶6. (C) Ironically, many of our interlocutors identified a stronger-than-expected recovery in developed markets as the most serious risk to the Chinese economy. China's December export figures surprised the market, said Qiao. Some recovery in the U.S. and other developed country markets, combined with low numbers from early 2009, would make Chinese export growth look strong in the first half of 2010. If export growth remained at about 20% beyond the first quarter, China risked overheating and the government would be forced to tighten monetary policy and slow spending, said Qu. Only Citibank's Shen disagreed, arguing that with China's share of G3 (U.S., EU, and Japan) imports hovering around 20 percent, these economies don't have capacity to absorb much more from China. Significantly higher-than-expected growth in both developed and emerging market economies was the only thing that could support a meaningful increase in Chinese exports, he said.

Bet on a Strengthening RMB in 2010, But When?

¶7. (C) All agreed that RMB exchange rate appreciation was likely this year, but our interlocutors disagreed on the timing. Shen predicted a return to gradual appreciation during the first half of 2010, driven by concerns about inflation and sterilization costs. He noted that large firms would welcome a stronger RMB for its impact on smaller rivals. With many exporting firms operating on thin margins, a three percent appreciation could force the smallest and weakest into the arms of larger competitors or out of business entirely. Chinese firms would benefit from consolidation, but the government worried about increased unemployment, said Shen. Qu agreed that appreciation was overdue, but suggested that Chinese policymakers needed to

see several months of strong export growth to provide them with political cover to allow a return to a gradual appreciation. He added that foreign pressure, particularly from the developed economies, wasn't helpful.

¶8. (C) Qiao also advised against pressuring China on currency issues. Senior leaders knew it had to happen and would allow the RMB to appreciate this year but were extremely sensitive to accusations that they were responding to foreign demands, she said. The "unfavorable political calendar," including U.S. Treasury's foreign currency report in April, the G20 meeting in June, and the Strategic and Economic Dialogue in mid-year, would prevent Chinese officials from taking action until the second half of 2010 when she predicted a relatively large and sudden appreciation of up to five percent.

¶9. (C) A stronger currency could contribute to weaker external demand for Chinese exports in the second half of the year and force leaders to start the process of rebalancing toward domestic consumption, said Shen, although he did not expect significant structural adjustment until 2012 or beyond. Chinese statistics suggesting domestic consumption was already increasing were not credible, said RBS's Simpfendorfer, and merely reflected temporary subsidies rather than real rebalancing. Without income growth or increased access to consumer credit, Chinese consumers were in no position to spend more, he said, so any real increase in private consumption would be a "slow-burning story." Qiao agreed, noting that household income had grown more slowly than GDP since 2000. She and Shen argued that real change was unlikely before the new leadership took charge in 2012 and would require at least five to ten years to achieve.
MARUT